

TESTIMONY OF ROBERT J. KABEL ON BEHALF OF  
THE BANK PRIVATE EQUITY COALITION

BEFORE THE  
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE  
AND GOVERNMENT SPONSORED ENTERPRISES  
AND THE  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND  
CONSUMER CREDIT

COMMITTEE ON FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES

JOINT HEARING ON  
PROMOTION OF CAPITAL AVAILABILITY TO AMERICAN  
BUSINESSES: A REVIEW OF THE FEDERAL RESERVES  
MERCHANT BANKING RULES

APRIL 4, 2001

## **Testimony of Robert J. Kabel on Behalf of The Bank Private Equity Coalition**

Chairmen Baker and Bachus, Ranking Members Kanjorski and Waters, members of the Subcommittees, I am Robert Kabel, counsel to the Bank Private Equity Coalition.<sup>1</sup> On behalf of BPEC, I want to thank you for your continuing interest in the regulatory implementation of the merchant banking authority enacted as part of the Gramm-Leach-Bliley Act (GLBA). BPEC sincerely appreciates your convening of this important hearing and the opportunity to present our views on implementation of the merchant banking provisions of GLBA.

### **I. Background**

BPEC was formed in early 1995 by the direct investment subsidiaries of several large commercial bank holding companies to address various statutory and regulatory issues. Prior to the enactment of GLBA, BPEC members had been involved for many years in direct investment activities through existing authorities, including SBICs and the so-called five percent companies. These direct investment subsidiaries have many years of direct investment experience and excellent earnings track records.

BPEC worked early in the 104<sup>th</sup> Congress with then House Banking Committee Chairman Jim Leach on the merchant banking language included in the first financial modernization bill that he introduced early in 1995. The same merchant banking language was included in every subsequent version of financial modernization legislation, including the legislation that was signed into law in November of 1999. The purpose of the merchant banking provision was to expand the existing direct investment authority of commercial bank holding company subsidiaries so they could compete more effectively with securities firms and insurance companies who were not subject to Glass-Steagall and Bank Holding Company Act restrictions.

Throughout the legislative process, BPEC recognized that the merchant banking provisions were intended to be self-executing and would not result in any significant additional regulatory requirements being imposed on this activity. The legislative language described in considerable detail the authority for classic portfolio investing in which investments are held only for the purpose of appreciation and there is no day-to-day management of portfolio companies, except in extraordinary circumstances.

Prior to the enactment of GLBA, the SBA regulated SBICs and the Federal Reserve Board regulated all other direct investments made through bank holding companies. The regulation of merchant banking activities was burdensome and often unpredictable. Federal Reserve examinations varied widely in regards to several critical issues. Therefore, BPEC and others in the industry advocated the enactment of the merchant banking provisions in GLBA as a means by which to streamline the regulation of merchant banking activities as well as provide for greater competitive equality.

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<sup>1</sup> BPEC Members include: DB Capital Partners, Inc.; BankBoston Capital, Inc.; Norwest Equity Partners; and, JPMorgan Capital Partners

Since enactment of GLBA, BPEC has worked with the federal financial regulatory agencies on implementation issues through a series of meetings and comment letters. Chairman Baker, we appreciate the attention you and the Capital Markets Subcommittee have given this important set of issues. BPEC strongly believes that the appropriate regulatory implementation of the GLBA merchant banking provisions in accordance with Congressional intent will determine whether this new statute leads to the modernization of our financial industry as Congress had intended. Nothing less than that is at stake here.

The question that remains is whether securities firms in particular will wish to charter financial holding companies, thereby broadening the types of financial institutions they are eligible to own under the newly authorized holding company structure. Merchant banking has been a significant business for most securities firms for many years. These firms will carefully scrutinize the regulatory requirements imposed on merchant banking activities conducted in a Financial Holding Company (FHC) before deciding whether to seek FHC status.

## II. Interim and Final Rules Regarding Merchant Banking Activities

In view of the intense scrutiny Congress gave merchant banking issues during the development of the GLBA, BPEC was surprised and disappointed when the Federal Reserve Board (Board) and the Treasury Department (Treasury) issued their interim merchant banking regulations on March 17, 2000 and the Board issued its proposed capital rules.

The interim rule established an extensive set of complex rules for merchant banking which BPEC members, and many other members of the financial community, thought to be exceedingly restrictive. We are pleased that the regulators took into account many of the extensive comments submitted regarding the interim rule and modified several of its provisions so that the final rule provides somewhat greater flexibility in certain of its provisions. Modifications made in the final rule include:

- Reduces penalties for exceeding the specified holding periods;
- Modifies the limitations on control and day-to-day management of portfolio companies to more accurately reflect the statutory provisions;
- Eliminates the internal record keeping requirements in favor of requiring compliance with the Federal Reserve SR Letter No.00-9, issued by the Board on June 22, 2000, thereby not layering additional requirements on top of those already required;
- Clarifies that once capital rules are in place, the aggregate merchant banking limits in the interim rule will be eliminated, thereby removing a major impediment for our members.

We remain concerned, however, that the final rule imposes a series of restrictions on FHC merchant banking operations that our non-FHC merchant banking competitors are not required to follow. In particular, BPEC remains troubled by the cross-marketing restrictions included in the final rule. The GLBA and the final regulations prohibit merchant banking portfolio companies

acquired under the new authority from marketing products and services of an affiliated depository institution and vice versa. These restrictions apply to portfolio companies in which an FHC owns more than a 5% voting equity interest. The regulators provide some level of flexibility in the final rule but have clearly stated that the statute does not permit them to go further. We believe the matter is subject to doubt nonetheless. The GLBA explicitly provides insurance companies involved in merchant banking with the authority to cross-market products and services. This apparent disparity is unfair and unwarranted, and should be changed. If regulatory relief is not forthcoming, BPEC recommends amending GLBA to permit financial institutions to cross-market products and services with portfolio companies.

### III. Revised Proposed Capital Regulations

BPEC, like almost everyone in the financial services industry, also was disappointed by the Federal Reserve's original proposed capital rules for FHC merchant banking activities. During the several year debate which led to the enactment of GLBA, none of the regulators ever publicly suggested that there should be the prospect of special capital rules for merchant banking activities. Congress rightly did not impose an excessive capital requirement because it recognized that existing merchant banking firms had a long history of making prudent investments and therefore did not require a separate capital rule.

The Federal Reserve's original proposal called for imposing a 50% capital charge on all merchant banking activities regardless of under what authority they were made, where they were made or who made them. The proposed capital charge was particularly inappropriate when applied to strong, prudent and experienced merchant banking firms. The original proposed rule covered both existing and future investments.

BPEC is pleased that the Federal Reserve carefully reviewed the substantial industry comments submitted in regards to the proposed capital rule and made significant changes in the revised proposal now out for comment. Comments made by this Committee and others in Congress were constructive and we appreciate the Committee's leadership on this critical issue. The revised proposal imposes a sliding scale of deductions from Tier 1 capital that are calculated as a percentage of the adjusted carrying value of the merchant banking portfolio. The percentage increases as the ratio of the size of the equity portfolio increases relative to Tier 1 capital. The capital charge ranges from a minimum of 8% for portfolio less than 15% of Tier 1 capital up to a capital charge of 25% for portfolio investments that exceed 25% of Tier 1 capital. The larger the portfolio relative to an FHC's Tier 1 capital, the higher the capital charge. Therefore, under any scenario, merchant banking investments will require more capital than the "well capitalized" level of 6% required of other assets.

The Federal Reserve's revised capital proposal establishes a special rule for investments made through an SBIC. Specifically, SBIC investments that do not exceed 15% of Tier 1 capital of the bank, or if the SBIC is housed in the FHC, 15% of the Tier 1 capital of all of its depository institution subsidiaries, are not subject to the capital deduction. However, SBIC investments count in determining the adjusted carrying value of the institution's merchant banking portfolio and, therefore, the marginal rate of capital that applies to the rest of the portfolio automatically increase if the SBIC investments push other investments into a higher deduction bracket.

Consequently, it seems that FHCs whose total merchant banking portfolios exceed 15% of Tier 1 capital will have a capital charge on any SBIC investments even if they are below the 15% level

While BPEC appreciates the fact that the Federal Reserve carefully reviewed and responded to many of the comments submitted on the original proposed rule, we continue to object to singling out any individual asset class for discriminatory treatment. As we stated in our comment letter on the original proposed capital rule, BPEC believes the Federal Reserve should utilize the internal capital allocation models of those FHCs with merchant banking operations. The Federal Reserve should review these models during the normal examination process and impose specific capital requirements only if the internal models are deemed inadequate to protect against the inherent risk in the institution's merchant banking portfolio.

BPEC's comment letter to the Federal Reserve on the revised proposed regulations will maintain this same position and, in response to specific requests for comment, will urge the Federal Reserve to grandfather investments made before March 13, 2000, the date the original proposed capital rules were published, and, in the alternative, to implement a three year phase on these investments.

#### IV. Conclusion

I want to thank you again for this opportunity to present the views of the Bank Private Equity Coalition on the final merchant banking regulations and the revised proposed merchant banking capital rule. Our members appreciate the continuing attention you and members of the Committee have given this important financial modernization issue. We look forward to working with you and other members of the House Financial Services Committee on the implementation of GLBA and, if necessary, to provide FHC merchant banking subsidiaries with appropriate flexibility with respect to cross-marketing opportunities.